

STATE OF WEST VIRGINIA



**AUDIT REPORT
OF**

**WEST VIRGINIA
STATE BOARD OF INVESTMENTS**

DECEMBER 31, 1995

**OFFICE OF THE LEGISLATIVE AUDITOR
POST AUDIT DIVISION**

CAPITOL BUILDING

CHARLESTON, WEST VIRGINIA 25305-0610

WEST VIRGINIA STATE BOARD OF INVESTMENTS

DECEMBER 31, 1995

WEST VIRGINIA LEGISLATURE
Joint Committee on Government and Finance

Theford L. Shanklin, CPA, Director
Legislative Post Audit Division
Building 1, Room W-329
1900 Kanawha Blvd., E.
Charleston, West Virginia 25305-0610



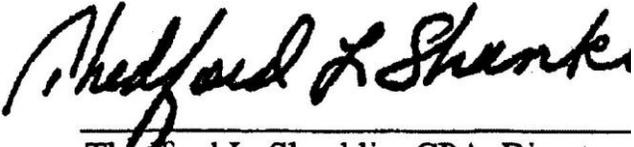
Area Code (304)
Phone: 347-4880
Fax: 347-4889

February 1, 1996

To Members of the West Virginia Legislature:

In compliance with the West Virginia Code, Chapter 12, Article 6, Section 15, one thousand nine hundred thirty-one, as amended, transmitted herewith is the report of the balance sheet of the West Virginia State Board of Investments. This report covers the calendar year 1995.

Respectfully submitted,



Theford L. Shanklin, CPA, Director
Legislative Post Audit Division

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WEST VIRGINIA STATE BOARD OF INVESTMENTS

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WEST VIRGINIA STATE BOARD OF INVESTMENTS

INTRODUCTION

The West Virginia State Board of Investments was created by the West Virginia Legislature on March 11, 1967. It is governed by Chapter 12, Article 6, Sections 1-18 inclusive of the West Virginia Code. The State Board of Investments has been continued until July 1, 1996, by Chapter 12, Article 6, Section 18.

The State Board of Investments consists of seven members (West Virginia Code, Chapter 12, Article 6, Section 3). The Governor is the Chairman. The West Virginia State Auditor and State Treasurer are the other two members designated by the code. The other four members are selected from a list of twelve persons submitted jointly by the Governor, State Treasurer and the State Auditor. Only two of the four appointed members can be chosen from the names submitted by the governor. These appointed members serve for a term of six years. The members serve without compensation, but are entitled to reasonable and necessary expenses actually incurred in discharging their duties.

The State Board of Investments has an executive director and three basic departments each with a chief officer. There is a chief operating officer, chief investment officer and chief financial officer. Each chief officer has his own support staff.

The West Virginia Code sections are specific in detailing the types of investments that can be utilized. Chapter 12, Article 6, Section 9 details permissible investments. Chapter 12, Article 6, Section 10, places restrictions on the percentages of each portfolio which may be invested in certain types of securities. Chapter 12, Article 6, Section 9a, specifies amounts that

can be transferred to the state's general revenue account. Chapter 12, Article 6, Section 6 deals with the establishment of a special revenue account to handle investigation of claims against third parties for investment losses, for consulting services regarding the restructuring of the office of the State Treasurer and costs of implementing the changes in the restructuring. The special revenue account was funded by securities lending income and recoveries from third parties. The authority for the account expired on June 30, 1995 and no additional funds have been placed in the account. The Board was authorized to deposit into the special revenue account and to expend a maximum of \$2 million annually from the account. Other Sections of Chapter 12, Article 6 deal with apportionments of interest earnings among state depositories and the standard of care to be exercised by the Board in making investments.

The investment pools are divided into two basic funds, the Consolidated Fund and Consolidated Pension Fund. Prior to July 1, 1995, the Consolidated Pension Fund consisted of four retirement accounts, two West Virginia Workers' Compensation accounts and a Pneumoconiosis account, all of which were accounted as single participant accounts. Effective July 1, 1995, the Consolidated Pension Fund was restructured to include the following pools: Short-Term Fixed Income Pool, Fixed Income Pool - Manager A, Fixed Income Pool - Manager B, Fixed Income Pool - Manager C, Workers' Compensation Loan Pool, Public Employees' Retirement System Loan Pool and the Teachers' Retirement Loan Pool. The Board's objective in the restructuring of the Consolidated Pension Fund was to reduce risk and increase diversification in each of the plans within the fund.

In the Consolidated Fund, the Cash Liquidity Pool consists of the operating funds of the State, funds held in trust by State agencies and funds invested by local governments. The

Enhanced Yield Pool consists of those operating funds of the State which the Board's staff have determined are not immediately needed to fund the State's liquidity requirements. The Government Money Market Pool is available for the investment of unexpended bond proceeds, debt service funds and amounts escrowed under the requirements of bond issuances. The Loss Amortization Fund was created to account for those participant claims of the general operating funds of the state which exceeded the underlying assets of the other funds. This excess of participant claims on net assets over underlying assets occurred as a result of the distribution of earnings to participants in various Board investment funds principally in the Unrestricted Pool, in excess of the true investment income experience of the funds in 1987 and 1988. West Virginia Code Chapter 12, Article 6, Section 5a, prohibits the State of West Virginia, the State Board of Investments or any other state officer to seek, or attempt to recover any monies that were over apportioned to those participants. As of December 31, 1995, stripped securities whose book value is \$54,402,775.63 with a maturity value of \$183,415,000.00, were being held in the Loss Amortization Account. These stripped securities mature at various times between February 15, 2005 and October 15, 2019. The Participant-Directed-Accounts are comprised of funds from individual state agencies with specific investment needs. The funds held by the participant directed accounts are not co-mingled, but rather each agency has 100% ownership of the underlying investments in a dedicated single account.

Each pool in the Consolidated Fund has its' own policy regarding the types of investments that may be utilized. For example, the Municipal Bond Commission mandates that no purchases or sales of investment can occur in accounts under their authority without their authorization. The Loss Amortization Account can only be invested in zero coupon bonds.

Each fund with the exception of the Loss Amortization Fund and the Participant-Directed-Accounts, has its own investment advisor who makes investment decisions within the parameters provided in the administrative regulations of the West Virginia Board of Investments and the West Virginia Code.

WEST VIRGINIA STATE BOARD OF INVESTMENTS

BOARD MEMBERS AND SENIOR STAFF

DECEMBER 31, 1995

BOARD MEMBERS

W. Gaston Caperton, III
Governor
Charleston Chairman

Larrie Bailey, State Treasurer
Charleston Member

Glen B. Gainer, III, State Auditor
Charleston Member

John T. Poffenbarger, Executive Secretary
Charleston Member

William T. Tracy
Huntington Member

Carlyle Farnsworth
Wheeling Member

Marie Prezioso
Charleston Member

SENIOR STAFF

H. Craig Slaughter Executive Director

D. Jerry Simpson Chief Operating Officer

Matthew E. Jones Chief Financial Officer

Diana Will Chief Investment Officer

Mark E. N. Asaad Chief Counsel

WEST VIRGINIA STATE BOARD OF INVESTMENTS
SUMMARY OF FINDINGS AND RECOMMENDATIONS

Service Fees on Industrial Development Loans

1. We learned the State Board of Investments deposited \$2,385,290.42 in management service fees on industrial development loans in other accounts rather than State General Revenue Fund during the period July 1, 1991 through December 31, 1995.

We recommend the State Board of Investments comply with Chapter 12, Article 6, Section 6 of the West Virginia Code, as amended. Also, we recommend the Board transfer the \$2,385,290.42 in management service fees earned on industrial development loans between July 1, 1991 and December 31, 1995, to the State General Revenue Fund and determine whether any additional management service fees earned between March 5, 1990 and June 30, 1991, may be due the State General Revenue Fund. (See pages 16-18.)

Security Lending Income

2. We learned the State Board of Investments had \$684,636.94 in security lending income held in an interest-bearing escrow account at State Street Bank as of August 31, 1995, which was shown as deposited in the State's accounting records on November 29, 1995.

We recommend the State Board of Investments transfer and record all investment earnings, including security lending income as soon as they become available. (See pages 18 and 19.)

Permissible Collateral Not Defined By Statute

3. The investment law does not state what types of securities constitute acceptable collateral.

We recommend the Legislature consider changes in Chapter 12, Article 6, Section 9 of the West Virginia Code, as amended, to specify those types of securities which could be accepted by the West Virginia State Board of Investments as collateral. (See pages 19 and 20.)

WEST VIRGINIA STATE BOARD OF INVESTMENTS

GENERAL REMARKS

We have completed an audit of the investment activity of the West Virginia State Board of Investments as required by West Virginia Code Chapter 12, Article 6, Section 15. Our audit covers the year ended December 31, 1995. However, due to the legal deadline of the report, February 1, 1996, we were unable to examine some transactions of the investment activity as set forth in our Independent Auditors' Opinion.

The Consolidated Pension Fund was composed of seven accounts during the period January 1, 1995 through June 30, 1995 as listed below:

<u>FUND</u>	<u>STATE STREET ACCOUNT</u>	<u>WEST VIRGINIA IMS NUMBER</u>
Judges' Retirement System	V301	8580
Public Safety Retirement System	V302	8581
Workers' Compensation Fund	V303	8582
Workers' Compensation Fund II	V304	8583
Pneumoconiosis Fund	V305	8584
Public Employees' Retirement System	V306	8585
Teachers' Retirement System	V307	8586

Effective July 1, 1995, the Consolidated Pension Fund was restructured into seven pools which were segregated into loan pools and investment pools. The investment pools were structured based on investment objectives and were created to diversify the pension fund investments. As of July 1, 1995, the Consolidated Pension Fund consisted of the following accounts:

<u>FUND</u>	<u>STATE STREET ACCOUNT</u>	<u>WEST VIRGINIA FIMS NUMBER</u>
Workers' Compensation Loan Pool	V303	8598
Public Employees' Retirement System Loan Pool	V306	8598
Teachers' Retirement Loan Pool	V307	8598
Short-Term Fixed Income Pool	V313	8598
Fixed Income Pool - Manager A	V314	8598
Fixed Income Pool - Manager B	V315	8598
Fixed Income Pool - Manager C	V317	8598

The Consolidated Fund was composed of 29 "pools" during 1995 which are identified below. The Cash Liquidity Pool (State Street Bank No. V36C) contains operating funds of the State, funds held in trust by State agencies, and funds invested by local governments. The Government Money Market Pool (State Street Bank No. V330) contains investments from agencies which may only be government securities. The available balance of the State's General Revenue Fund is invested through the Enhanced Yield Pool (State Street Bank No. V363). The remaining pools contain specific investments for individual agencies due to constitutional or bonding restrictions prohibiting commingling with the Cash Liquidity Pool and Enhanced Yield Pool.

1. **Construction Trust Fund - Huntington Toll Bridge –
State Street Bank No. V321 - West Virginia FIMS No. 8593**

This Construction Trust Fund is restricted to investments made solely on the behalf of the Huntington Toll Bridge and may only be invested in U.S. Treasury obligations. This pool was closed on March 21, 1995.

2. **The School Fund - State Street Bank No. V322 - West Virginia FIMS No. 8691**

The School Fund is not an investment pool within the Consolidated Fund. The Office of the State Treasurer serves as the staff agency for the "Board of the School Fund". The Fund is restricted to investments in securities of the United States Government or the State of West Virginia.

3. Lottery Defeasance - State Street Bank No. V323 - West Virginia FIMS No. 8593

This pool was established October 1987. This pool is used to annuitize the lottery winners by buying U.S. Treasury Zero Coupon Bonds.

4. School Building Authority - State Street Bank No. V326 - West Virginia FIMS No. 8593

This single agency pool was set up in February 1990 to invest the proceeds from the School Building Authority Capitol Improvement Revenue Bonds. The money is held in this account until the funds are allocated to the county school systems.

5. State Loan Pool - State Street Bank No. V329 - West Virginia FIMS No. 8593

A new pool established February 1993. All mortgage and Economic Development Authority loans were transferred from the Unrestricted Pool to this pool.

**6. Government Money Market Pool - State Street Bank No. V330 –
West Virginia FIMS No. 8593**

This Pool is limited to investments made in securities offered by U.S. Treasury, U.S. Government Agencies, or investments collateralized by U.S. Treasury securities.

7. Loss Amortization - State Street Bank No. V333 - West Virginia FIMS No. 8577

This pool contains zero coupon bonds bought to amortize the losses in Pool 100 and 140. At the maturity date of the bonds, the funds will be transferred to Pools 100 and 140.

**8. Municipal Bond Commission - Fairmont 85 Water Revenue Esc -
State Street Bank No. V334 - West Virginia FIMS No. 8593**

This account was created December 29, 1988 to hold escrowed investments for the Municipal Bond Commission. These investments are escrowed for the retirement of Fairmont Water Revenue Bonds. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

**9. Municipal Bond Commission - Huntington Bridge 65 Revenue - State Street Bank No.
V335 - West Virginia FIMS No. 8593**

This account was created December 29, 1988 to hold escrowed investments for the Municipal Bond Commission. This account is for the Huntington Toll Bridge obligation. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

10. **Municipal Bond Commission - WVU Project 11 Escrow - State Street Bank No. V336 - West Virginia FIMS No. 8593**

This Escrow Account is for West Virginia University's Project 11. No purchases or sales of investments may occur without the authorization of the Municipal Bond Commission.

11. **Municipal Bond Commission - County Schools - State Street Bank No. V337 - West Virginia FIMS No. 8593**

This pool is for the investment of funds held by county schools systems. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

12. **Municipal Bond Commission - Public Services Districts - State Street Bank No. V338 - West Virginia FIMS No. 8593**

This pool is for the investment of Public Service District Funds. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

13. **Municipal Bond Commission - State Street Bank No. V339 - West Virginia FIMS No. 8593**

No purchases or sales of investments may occur without Municipal Bond Commission authorization.

14. **Municipal Bond Restricted Pool - State Street Bank No. V340 - West Virginia FIMS No. 8593**

This fund was opened July 1, 1992 for the Municipal Bond Commission to address their accounting requirements. Securities and cash were transferred out of the Government Money Market Pool - State Street Bank No. V330.

15. **Municipal Bond Commission - County Revenue - State Street Bank No. V341 - West Virginia FIMS No. 8593**

This Municipal Bond Commission Account is for the investment of county revenues. No purchases or sales of investments may occur without the authorization of the Municipal Bond Commission.

16. **Municipal Bond Commission - General Obligation - State Street Bank No. V342 - West Virginia FIMS No. 8593**

This Municipal Bond Commission Account is for the defeasance of general obligations of municipalities, only U.S. Treasury Securities may be purchased.

17. **Municipal Bond Commission - Combined Revenue Account - State Street Bank No. V343 - West Virginia FIMS No. 8593**

This account was created December 29, 1988 to hold escrowed investments for the Municipal Bond Commission. This account is for the investment of State Building Commission Funds. No purchases or sales of Investments may occur without Municipal Bond Commission authorization.

18. **Municipal Bond Commission - Hancock County Schools 83G/0 - State Street Bank No. V344 - West Virginia FIMS No. 8593**

This account was created December 29, 1988 to hold escrowed investments for the Municipal Bond Commission. These investments are escrowed for the retirement of Hancock County Schools general obligation bonds. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

19. **Municipal Bond Commission - Fairmont 85 Sewer Revenue - State Street Bank No. V345 - West Virginia FIMS No. 8593**

This account was created December 29, 1988 to hold escrowed investments for the Municipal Bond Commission. These investments are escrowed for the retirement of Fairmont Sewer Revenue Bonds. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

20. **Municipal Bond Commission - Escrow Agent For Board of Regents – State Street Bank No. V346 - West Virginia FIMS No. 8593**

This account was created January 26, 1989 to hold escrowed investments for the Municipal Bond Commission. No purchases or sales of investments may occur without Municipal Bond Commission authorization.

21. **Municipal Bond Commission - Wetzel City Schools – State Street Bank No. V347 - West Virginia FIMS No. 8593**

This account was opened in October 1993. No purchases or sales may occur without Municipal Bond Commission authorization.

22. **Department of Transportation Special Highway Fund - State Street Bank No. V348 - West Virginia FIMS No. 8593**

The proceeds from the bond issue are invested in repurchase agreements. This pool was closed on March 21, 1995.

23. **Department of Transportation Zero Coupon - State Street Bank
No. V349 - West Virginia FIMS No. 8593**

The funds represent the investments of the special highway fund set up by Chapter 17, Article 16A, Section 23 of the West Virginia Code. This pool was closed on March 21, 1995.

24. **West Virginia Economic Development Authority Insurance Fund -
State Street Bank No. V350 - West Virginia FIMS No. 8593**

This fund was opened July 29, 1992 for the West Virginia Economic Development Authority. The securities in this fund are used to insure payment on bond issues.

25. **DOH - Parkway Authority - State Street Bank No. V351 - West Virginia FIMS NO.
8593**

The funds represent investments made from funds transferred to the Division of Highways as allowed by Chapter 17, Article 16A, Section 22 of the West Virginia Code. This pool was closed on March 21, 1995.

26. **Municipal Bond Commission - Wayne County Board of Education -
State Street Bank No. V352 - West Virginia FIMS No. 8593**

This account was opened on December 28, 1993. No purchases or sales may occur without Municipal Bond Commission authorization.

27. **Municipal Bond Commission - Berkeley County Schools - State Street Bank No.
V353 - West Virginia FIMS No. 8593**

This account was created March 15, 1995 to hold escrowed investments for the Municipal Bond Commission. These investments are escrowed for the retirement of Berkeley County Schools general obligation bonds. No purchase or sales may occur without Municipal Bond Commission authorization.

28. **Cash Liquidity Pool - State Street Bank No. V36C - West Virginia FIMS No. 8593**

This investment pool is composed of the operating funds of the State, funds held in trust by State agencies, and funds invested by local governments. This pool is limited to securities with remaining maturities of not greater than three hundred ninety-seven (397) days and the dollar weighted-average-maturity of the securities in the portfolio may not exceed ninety (90) days. The pool is made up of two portfolios known as Cash Liquidity Pool (State Street Bank No. V361) and Cash Liquidity Pool (State Street Bank No. V362).

29. Enhanced Yield Pool - State Street Bank No. V363 - West Virginia FIMS No. 8593

This investment pool is composed of the operating funds of the State which the Board's staff have determined are not immediately needed to fund the State's liquidity requirements. This pool is limited to securities with remaining maturities of not greater than (3.0) three years and the dollar weighted-average-maturity of the securities in the portfolio may not exceed (1.0) one year.

Management of The Funds

The activities of the pension funds were administered by the following advisors during calendar year 1995:

Judges' Retirement System:

Kemper Asset Management Company (01/01/95-06/30/95)

Public Safety Retirement System:

Kemper Asset Management Company (01/01/95-06/30/95)

Workers' Compensation Fund:

Investment Advisors, Inc. (01/01/95-06/30/95)

Workers' Compensation Fund II:

Kemper Asset Management Company (01/01/95-06/30/95)

Pneumoconiosis Fund:

Kemper Asset Management Company (01/01/95-06/30/95)

Public Employees' Retirement System:

Investment Advisors, Inc. (01/01/95-06/30/95)

Teachers' Retirement System:

Kemper Asset Management Company (01/01/95-06/30/95)

Short-Term Fixed Income Pool:

Fischer, Francis, Trees & Watts, Inc. (07/01/95-12/31/95)

Fixed Income Pool - Manager A:

Investment Advisors, Inc. (07/01/95-12/31/95)

Fixed Income Pool - Manager B:

Lincoln Capital Management Company (07/01/95-12/31/95)

Fixed Income Pool - Manager C:
Western Asset Management Company (07/01/95-12/31/95)

The activities of the Workers' Compensation Loan Pool, Public Employees' Retirement System Loan Pool and Teachers' Retirement Loan Pool were administered by the staff of the State Board of Investments during the period July 1, 1995 through December 31, 1995.

Also, the activities of the account "pools" in the Consolidated Fund were administered by the following advisors during calendar year 1995:

Cash Liquidity Pool - State Street Bank No. V36C:
Huntington National Bank West Virginia
Bank One, West Virginia, Charleston, N.A.

Enhanced Yield Pool - State Street Bank No. V363:
Bank One, West Virginia, Charleston, N.A.

Government Money Market Pool - State Street Bank No. V330:
Brinson Partners, Inc.

During calendar year 1995, all other account "pools" in the Consolidated Fund commonly referred to as "single account pools" were administered by the staff of the State Board of Investments. However, the activities of these accounts were directed by the management of the individual agencies.

INVESTMENT POLICY

Service Fees on Industrial Development Loans

Chapter 12, Article 6, Section 6 of the West Virginia Code, as amended, states in part,

"(a) The board shall make a charge against the earnings of the various funds managed by the board for all necessary expenses of the board. The charge shall be on a pro rata basis of actual

earnings of the various funds managed by the board. **The charge shall be deposited to the credit of the general revenue fund.** (b) There is hereby created in the state treasury a special revenue account to be known as the "loss expenses account." The purpose of this account is to provide funds to the board of investments to pay costs, fees and expenses incurred, or to be incurred... That special revenue account shall be funded by depositing income derived by the board from securities lending and recoveries from third part...." **(Emphasis Added)**

During our current audit, we learned through our examination of securities lending income that the State Board of Investments had an established practice of crediting management fees relating to industrial development loans to the Investment Loss Legal Expenses Fund - Fund Number 8563. Our research indicates the Investment Loss Legal Expenses Fund was created by legislation which became effective March 5, 1990, for the purpose of providing funding for investigation and pursuit of claims against third parties for the investment losses incurred by the State during the 1980's. The account was to be funded by recoveries from third parties and up to two million dollars annually of income derived from securities lending.

Our examination of security lending indicated that all such income received in calendar year 1995 was placed in the Security Lending Fund - Fund Number 8565. Also, we noted regular deposits being made to the Investment Loss Legal Expenses Fund during the period January 1, 1995 through June 30, 1995. Since no recoveries from brokers or security lending income was placed in the account during this period, we asked Board personnel concerning the source of the income into the Investment Loss Legal Expenses Fund. Board personnel told us the deposits represented management service fees received from various industrial development loans managed by the Board which they had been advised by in-house legal counsel could be placed in the Investment Loss Legal Expenses Fund shortly after the fund

was created in 1990. However, we believe the provisions of Chapter 12, Article 6, Section 6 of the West Virginia Code, as amended, specify that management fees shall only be credited to the State General Revenue Fund.

We proceeded to examine all deposits of these types of service fees received during the period March 5, 1990 through December 31, 1995. The following schedule shows the amount of such fees which we believe are due and owed the State General Revenue Fund and the incorrect funds into which they have been placed:

<u>PERIOD</u>	<u>NAME OF FUND</u>	<u>FUND NUMBER</u>	<u>AMOUNT OF FEES COLLECTED</u>
7/1/95-12/31/95	Banking Service Expenses	8567	\$ 237,220.72
7/1/94-06/30/95	Investment Loss Legal Expenses	8563	536,344.92
7/1/93-06/30/94	Investment Loss Legal Expenses	8563	519,609.04
7/1/92-06/30/93	Investment Loss Legal Expenses	8563	520,711.43
7/1/91-06/30/92	Investment Loss Legal Expenses	8563	<u>571,404.31</u>
			<u>\$2,385,290.42</u>

We recommend the State Board of Investments comply with Chapter 12, Article 6, Section 6 of the West Virginia Code, as amended. Also, we recommend the Board transfer the \$2,385,290.42 in management service fees earned on industrial development loans between July 1, 1991 and December 31, 1995 to the State General Revenue Fund and determined whether any additional management service fees earned between March 5, 1990 and June 30, 1991, may be due the State General Revenue Fund.

Security Lending Income

In accordance with the provisions of Chapter 12, Article 6 of the West Virginia Code, the State Board of Investments had engaged in a security lending program administered

through contract by State Street Bank of Boston, Massachusetts during the period December 3, 1990 through August 31, 1995. The authority for the security lending program terminated on August 31, 1995 based on unanimous vote of the Board at the June 22, 1995 Board meeting.

Our audit of security lending income for calendar year 1995 indicates that when the security lending program ended on August 31, 1995, the State Board of Investments had gross earnings of \$758,970.33 available in an escrow account at State Street Bank. This amount represented security lending income for the period February 1, 1995 through August 31, 1995. The gross amount due the State was reduced by a total of \$74,333.39 in program closeout costs which were shared with the bank on the same basis as the security lending income leaving the State with \$684,636.94 available to transfer to the accounts of the State.

However, these moneys were not recorded as a deposit on the accounting records of the State until November 29, 1995, which means these moneys had been unable to be used to pay bills or other purposes for approximately three months after they had been earned and where available. During this three-month period, these funds earned a total of \$9,911.46 in interest earning while being held in the escrow account. We believe the State Board of Investments should transfer and record all investment earnings in the State's accounting records as soon as they become available.

We recommend the State Board of Investments transfer and record all investment earnings, including security lending income as soon as they become available.

COLLATERAL

Permissible Collateral Not Defined By Statute

Our prior audit for calendar year 1994 showed several instances where the underlying securities obligated to the Board as collateral supporting repurchase agreements between the State Board of Investments and various brokers during 1994 did not appear to be a permissible investment under Chapter 12, Article 6, Section 9 of the West Virginia Code, as amended. Our current audit for calendar year 1995 did not show any further occurrences.

However, our review of Chapter 12, Article 6 of the West Virginia Code shows no references to those securities which the Board should require as collateral. We continue to believe an amendment to the investment law should be considered which would spell out the specific types of securities making up permissible investments in Chapter 12, Article 6, Section 9 of the West Virginia Code, as amended, which could be accepted by the Board as collateral.

We recommend the Legislature consider changes in Chapter 12, Article 6, Section 9 of the West Virginia Code, as amended, to specify those types of securities which could be accepted by the West Virginia State Board of Investments as collateral.

EVALUATION OF THE CONSOLIDATED PENSION FUND

We obtained copies of the rating service's evaluation of the Consolidated Pension Fund's performance for the quarters ended December 31, 1994, March 31, 1995, June 30, 1995 and September 30, 1995 as prepared by Hewitt Associates. The rating service's evaluation for the quarter ended December 31, 1995 was not yet available at the conclusion of our current fieldwork (January 30, 1996). We reviewed the rating service's reports and noted the following observations:

<u>FUND</u>	<u>TIME</u>	<u>RATE OF RETURN FOR</u>		
	<u>WEIGHTED</u>	<u>QUARTER ENDED</u>		
	<u>09/30/95</u>	<u>06/30/95</u>	<u>03/31/95</u>	<u>12/31/94</u>
Judges'	1.61%	5.25%	4.60%	0.10%
Public Safety	1.63%	5.31%	4.62%	0.23%
Workers' Compensation	1.59%	5.16%	4.21%	0.85%
Workers' Compensation II	1.64%	5.72%	4.57%	0.65%
Pneumoconiosis	1.64%	5.52%	4.64%	0.41%
Public Employees'	1.63%	5.63%	4.46%	0.72%
Teachers'	1.60%	5.59%	4.71%	0.42%

The asset allocation reported by Hewitt Associates for the quarters ended December 31, 1994, March 31, 1995, and June 30, 1995 were as follows:

<u>FUND</u>	<u>QUARTER ENDED</u>		
	<u>06/30/95</u>	<u>03/31/95</u>	<u>12/31/94</u>
Judges' Retirement:			
Bonds	88.3%	92.8%	93.8%
Cash Equivalents and Cash	11.7%	7.2%	6.2%
Public Safety:			
Bonds	93.6%	93.4%	95.9%
Cash Equivalents and Cash	6.4%	6.6%	4.1%
Workers' Compensation:			
Bonds	82.7%	95.7%	94.2%
Cash Equivalents and Cash	17.3%	4.3%	5.5%
Private Placements	0.0%	0.0%	0.3%
Workers' Compensation II:			
Bonds	84.0%	85.2%	84.8%
Cash Equivalents and Cash	16.0%	14.8%	15.2%
Pneumoconiosis:			
Bonds	84.3%	85.9%	85.6%
Cash Equivalents and Cash	15.7%	14.1%	14.4%

Public Employees':			
Bonds	90.6%	99.2%	93.4%
Cash Equivalents and Cash	9.4%	0.8%	6.6%
Teachers':			
Bonds	74.5%	83.4%	86.4%
Cash Equivalents and Cash	25.5%	16.6%	13.6%

After the restructuring of the Consolidated Pension Fund on July 1, 1995, the asset allocation as reported by Hewitt Associates for the quarter ended September 30, 1995 for those pools with investment advisors was as follows:

<u>FUND</u>	<u>BONDS</u>	<u>CASH AND CASH EQUIVALENTS</u>	<u>PRIVATE PLACEMENTS</u>
Short-Term Fixed Income	85.3%	14.7%	0.0%
Fixed Income Pool-Manager A	93.8%	6.2%	0.0%
Fixed Income Pool-Manager B	75.5%	24.5%	0.0%
Fixed Income Pool-Manager C	80.1%	19.9%	0.0%

Relative conditions in the financial markets are subject to change within the year. As a result, certain aspects of portfolio diversification while aiding performance of the fund in one quarter of the year may be detrimental to performance in another quarter of the year. The performance rankings are shown on a scale where the 99th percentile is the best performing 1% of the peer group, while the 1st percentile is the worst performing 1% of the peer group. The rankings of the performance of the trust funds were as follows:

<u>FUND</u>	<u>PERFORMANCE RANKING FOR QUARTER ENDED</u>			
	<u>09/30/95</u>	<u>06/30/95</u>	<u>03/31/95</u>	<u>12/31/94</u>
Judges'	22	38	50	28
Public Safety	23	40	52	36

Workers' Compensation	18	36	29	80
Workers' Compensation II	24	57	46	69
Pneumoconiosis	24	49	54	49
Public Employees'	23	54	40	73
Teachers'	20	52	58	51

INDEPENDENT AUDITORS' OPINION

Members of the West Virginia Legislature
State Capitol
Charleston, West Virginia

We have audited the accompanying balance sheet of the West Virginia State Board of Investments as of December 31, 1995. The financial statement is the responsibility of the management of the West Virginia State Board of Investments. Our responsibility is to express an opinion on the financial statement based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Due to the report date set forth in Chapter 12, Article 6, Section 15 of the West Virginia Code, we were unable to perform auditing procedures regarding tests of market values in both the Consolidated Fund and Consolidated Pension Fund.

In our opinion, except for the effects of the matters discussed in paragraph three above, if any, as might have been determined if these additional auditing procedures had been performed, the balance sheet referred to in the first paragraph above presents fairly, in all material respects, the financial position of the West Virginia State Board of Investments as of December 31, 1995, in conformity with generally accepted accounting principles.

Respectfully submitted,



Theoford L. Shanklin, CPA, Director
Legislative Post Audit Division

January 30, 1996

Auditors: Michael E. Sizemore, CPA, Supervisor
Timothy C. Butler, CPA, Auditor-in-Charge
Larry D. Bowman
Jason A. Haught

Debra A. Sheets

WEST VIRGINIA STATE BOARD OF INVESTMENTS

BALANCE SHEET

DECEMBER 31, 1995

	<u>CONSOLIDATED FUND</u>	<u>CONSOLIDATED COMPENSION FUND</u>	<u>COMBINED TOTALS MEMORANDUM ONLY</u>
Assets:			
Cash	\$ -0-	\$ -0-	\$ -0-
Investments at Book Value Notes 3 and 4 (Par Value \$1,412,779,052.55 Consolidated Fund)	1,266,169,189.74	-0-	1,266,169,189.74
Market Value Notes 3 and 4 (Par Value \$103,665,421.33 Consolidated Fund, \$3,754,297,825.36 Consolidated Pension Fund)	103,844,681.13	3,897,270,433.75	4,001,115,114.88
Other Assets Note 4	4,231,650.00	-0-	4,231,650.00
Interest Receivable	9,104,350.10	2,326,683.12	61,431,033.22
Receivable for Investments Sold	<u>-0-</u>	<u>83,535,374.35</u>	<u>83,535,374.35</u>
Total Assets	<u>\$1,383,349,870.97</u>	<u>\$4,033,132,491.22</u>	<u>\$5,416,482,362.19</u>
Liabilities and Fund Balances:			
Due Investors	\$1,511,746,591.93	\$3,834,314,290.24	\$5,346,060,882.17
Payable for Investments Purchased	-0-	178,229,178.64	178,229,178.64
Dividend Distribution Payable	513,251.77	20,264,347.95	20,777,599.72
Due West Virginia State General Fund	<u>94,915.34</u>	<u>324,674.39</u>	<u>419,589.73</u>
Total Liabilities	1,512,354,759.04	4,033,132,491.22	5,545,487,250.26
Fund Balance (Deficit) Note 5	<u>(129,004,888.07)</u>	<u>-0-</u>	<u>(129,004,888.07)</u>

Total Liabilities and Fund Balances	<u>\$1,383,349,870.97</u>	<u>\$4,033,132,491.22</u>	<u>\$5,416,482,362.19</u>
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See Notes to Financial Statement

WEST VIRGINIA STATE BOARD OF INVESTMENTS

CONSOLIDATED FUND AND CONSOLIDATED PENSION FUND

NOTES TO FINANCIAL STATEMENT

DECEMBER 31, 1995

1. DESCRIPTION OF THE ENTITY

The accompanying financial statements reflect the investment balances of the Consolidated Fund and the Consolidated Pension Fund (the "Funds") under the management of the Board of Investments (the Board) as provided in the West Virginia Code Chapter 12-6-8(a) and (b). The Code established these funds to provide for the investment of State funds, the investment of local government funds and the investment of the State's pension funds. These financial statements reflect only the investments of the pools under the management of the Board and do not reflect any other assets or liabilities of the various pool participants.

The individual pools within the Funds and a brief description of each follows.

Consolidated Fund

Cash Liquidity Pool - This pool is composed of the operating funds of the State, funds held in trust by State Agencies, and funds invested by local government.

Enhanced Yield Pool - This pool is composed of the operating funds of the State which the Board's staff have determined are not immediately needed to fund the State's liquidity requirements.

Government Money Market Pool - This pool is available for the investment of unexpended bond proceeds, debt service funds and amounts escrowed under the requirements of bond issuances.

Loss Amortization Pool - This pool was created to account for those participant claims of the general operating funds of the State which exceeded the underlying assets of the other pools. This excess of participant claims on net assets over

underlying assets occurred as a result of the distributions of earnings to participants in various Board investment pools, principally the unrestricted pool, in excess of the true investment income experience of the pools, principally in 1987 and 1988.

Participant Directed Accounts (PAD) - The (PAD) are comprised of funds from individual State agencies with specific investment needs. The funds held by the PAD are not commingled, but rather each agency has 100% ownership of the underlying investments in a dedicated, single account pool.

Each pool, with the exception of the Loss Amortization Pool and PAD, has its own investment advisor who makes investment decisions within the parameters provided in the administrative regulations of the West Virginia State Board of Investments. All investment decisions are then executed by the Board.

Consolidated Pension Fund

The various investment pools which comprise the Consolidated Pension Fund have been established to provide for the investment of funds of the Public Employees' Retirement System, Teachers' Retirement System, Public Safety Retirement System, Judges' Retirement System, Workers' Compensation Fund, Workers' Compensation Fund II and Pneumoconiosis Fund. Each pool has its own investment advisor(s) who makes investment decisions within the parameters provided in the Administrative regulations of the West Virginia State Board of Investments.

2. SIGNIFICANT ACCOUNTING POLICIES

- a. Basis of Accounting - The Board is the investment vehicle of the State of West Virginia and its component units, all of which are governmental entities. As a result, as permitted within governmental accounting standards, the Board carries investments in the Consolidated Pension Fund at fair market value while in the Consolidated Fund, investments are recorded at cost, adjusted for amortization of premium and accretion of discount, except for the Enhanced Yield Pool for which investments are recorded at fair market value. Commissions on purchases of securities by the Board are generally an unidentified component of the security price quoted by the seller and are included in the investment cost or carrying value.
- b. Investment Transactions - Investment transactions are accounted for on a trade date basis.
- c. Investment Gains and Losses - Gains and losses on sales of investment securities are recognized at the time of sale by the specific identification method.
- d. Interest Income - Interest income is recognized as earned on the accrual method.

- e. Allowance for Possible Loan Losses - The allowance for possible loan losses is available to absorb future loan charge-offs. The allowance is increased by provisions charged to operations and reduced by losses or charge-offs, net of recoveries. The amount charged to operations is based on several factors including: analytical reviews of loan loss experience in relationship to outstanding loans; a continuing review of problem loans and overall portfolio quality, including analysis of the quality of the underlying collateral; and management's judgment on the impact of current and expected economic conditions on the portfolio.

- f. Expenses - All the expenses of the Funds, except for fees paid for banking services and a service fee, are paid by the Board of Investments from appropriations granted by the State Legislature. Fees for banking services are paid by the Board through the use of a portion of the investment earnings of the Cash Liquidity Pool. The pools are assessed a management service fee by the Board. The service fee ranges from a flat fee to 1¼% of the monthly earnings of the pool. This service fee is remitted to the general funds of the State on a monthly basis.

3. INVESTMENTS

Risk Categorization - In accordance with the provisions of Statement No. 3 of the Governmental Accounting standards Board, investments are classified as to level of risk by the three categories described below:

Category 1 - Insured or registered, or securities held by the State or its agent in the State's name.

Category 2 - Uninsured and unregistered, or securities held by the counterparty's trust department or agent in the State's name.

Category 3 - Uninsured and unregistered, or securities held by the counterparty's trust department or agency but not in the State's name.

Investments at December 31, 1995, by security type and level of risk category, are as follows:

<u>Security Type</u>	<u>CONSOLIDATED FUND</u>	<u>CONSOLIDATED PENSION FUND</u>	<u>TOTAL</u>	<u>CATEGORY 1</u>
U.S. government and government agency obligations	\$ 766,426,725.83	\$3,099,747,324.05	\$3,866,174,049.88	\$3,866,174,049.88
State & local government securities	7,157,600.00	-0-	7,157,600.00	7,157,600.00
Corporate bonds and notes	18,748,485.03	345,008,314.00	363,756,799.03	363,756,799.03
Repurchase agreements	376,303,755.07	392,954,833.79	771,258,588.86	771,258,588.86
Collateralized mortgage obligations	-0-	22,376,014.37	22,376,014.37	22,376,014.37
Commercial Paper	83,393,653.75	-0-	83,393,653.75	83,393,653.75
Loans - net of allowance for possible loan losses	114,983,013.94	37,183,947.54	152,166,961.48	152,166,961.48
Other	<u>1,000,637.25</u>	<u>-0-</u>	<u>1,000,637.25</u>	<u>1,000,637.25</u>
	<u>\$1,370,013,870.87</u>	<u>\$3,897,270,433.75</u>	<u>\$5,267,284,304.62</u>	<u>\$5,267,284,304.62</u>

The repurchase agreements included in Category 1 are owned by the Participant Directed Accounts.

**COMPARISON OF BOOK AND MARKET
WEST VIRGINIA STATE BOARD OF INVESTMENTS
DECEMBER 31, 1995**

<u>DESCRIPTION</u>	<u>CONSOLIDATED FUND</u>		<u>CONSOLIDATED PENSION FUND</u>	
	<u>BOOK</u>	<u>MARKET</u>	<u>BOOK</u>	<u>MARKET</u>
U.S. government and government agency obligations	\$ 766,033,553.57	\$ 795,229,306.50	\$2,993,288,164.77	\$3,099,747,324.05
State & local government securities	7,157,600.00	N/A	0.00	0.00
Corporate bonds and notes	18,642,214.06	18,748,432.30	332,500,169.94	345,008,314.00
Repurchase agreement	378,303,755.07	378,303,755.07	392,954,833.79	392,954,833.79
Collateralized Mortgage obligations	0.00	0.00	22,060,419.83	22,376,014.37
Commercial Paper	83,402,584.35	83,366,797.04	0.00	0.00
Loans - net of allowance for possible loan losses	114,983,013.94	N/A	37,183,947.54	N/A
Other	<u>1,000,637.25</u>	<u>N/A</u>	<u>0.00</u>	<u>0.00</u>
	<u>\$1,369,523,358.24</u>	<u>\$1,275,648,290.91</u>	<u>\$3,777,987,535.87</u>	<u>\$3,860,086,486.21</u>

N/A - Market Values - Investments held by the Funds at December 31, 1995 include loans consisting primarily of economic development and mortgage loans. These loans have no ready market values and, therefore, no market value is reported. State and local government securities (SLGS) are direct obligations of the U.S. government, issued to State and local government entities to provide those governments with required cash flows at yields which do not exceed IRS arbitrage limits. As the SLGS are issued to retire debt investments, market values are not a meaningful measure.

4. LOANS AND ALLOWANCE FOR POSSIBLE LOAN LOSSES

As occasionally required by the Legislature, the pools will originate loans, loan funds to other State agencies for the purpose of originating loans and purchase loans originated by other State agencies. These loans are generally limited to economic development loans and mortgage loan programs within the State of West Virginia.

In 1991, the Board implemented a policy to review its loan portfolio for purposes of the establishment of an allowance for possible loan losses. This allowance in the aggregate amounted to \$2,605,000.00 at December 31, 1995.

The composition of loans and the allowance for possible loan losses at December 31, 1995 are as follows:

	<u>CONSOLIDATED FUND</u>	<u>CONSOLIDATED PENSION FUND</u>
Loans:		
West Virginia Economic Development Authority	\$103,979,448.29	\$16,848,200.04
Other	<u>13,553,565.65</u>	<u>20,390,747.50</u>
	117,533,013.94	37,238,947.54
Less allowance for possible loan losses	<u>2,550,000.00</u>	<u>55,000.00</u>
	<u>\$114,983,013.94</u>	<u>\$37,183,947.54</u>

The following loans, Franklin Theater Building, Greenbrier Building, Fairmont Avenue Apartments, Elizabeth Apartments and St. James Apartments were previously reported in nonaccrual status. These properties have been acquired by the Board through foreclosure proceedings and are now recorded as other assets.

**5. SCHEDULE FOR STATUS OF INVESTMENT DIFFERENCE
WEST VIRGINIA STATE BOARD OF INVESTMENTS
DECEMBER 31, 1995**

The following schedule updates as of December 31, 1995, the carrying cost and market value of the securities purchases to fund the investment difference.

Investment difference from the Unrestricted and Restricted pools.	\$183,407,663.70
Additional fund transfers to purchase securities.	<u>7,336.30</u>
Total Fund balance to be accounted for.	<u>\$183,415,000.00</u>

Securities Held to Offset the Difference:

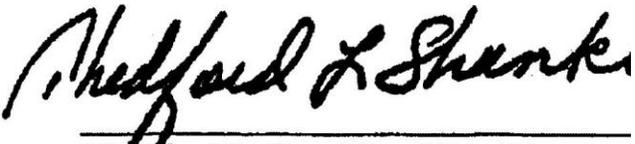
<u>DESCRIPTION</u>	<u>MATURITY</u>	<u>CARRYING COST</u>	<u>MARKET VALUE</u>	<u>FACE VALUE</u>
Zero Coupon Bonds	02/15/2005	\$10,681,063.82	\$13,171,400.00	\$ 22,000,000.00
Zero Coupon Bonds	08/15/2005	12,997,533.80	18,011,310.00	31,000,000.00
Zero Coupon Bonds	02/15/2010	5,592,197.26	8,674,000.00	20,000,000.00
Zero Coupon Bonds	11/15/2111	21,504,411.51	30,876,153.00	80,300,000.00
Zero Coupon Bonds	10/15/2019	<u>3,627,569.24</u>	<u>6,653,608.10</u>	<u>30,115,000.00</u>
Total Zero Coupon Bonds		<u>\$54,402,775.63</u>	<u>\$77,386,471.10</u>	<u>\$183,415,000.00</u>
Current difference (Fund Balance less Carrying Cost)		<u>\$129,004,888.07</u>		

STATE OF WEST VIRGINIA

OFFICE OF THE LEGISLATIVE AUDITOR, TO WIT:

I, Thedford L. Shanklin, CPA, Director of the Legislative Post Audit Division, do hereby certify that the report of audit appended hereto was made under my direction and supervision, under the provisions of the West Virginia Code, Chapter 12, Article 6, Section 15, as amended, and that the same is a true and correct copy of said report.

Given under my hand this 1st day of February 1996.

A handwritten signature in black ink, reading "Thedford L. Shanklin". The signature is written in a cursive style and is positioned above a horizontal line.

Thedford L. Shanklin, CPA, Director
Legislative Post Audit Division

Copy forwarded to each member of the Legislature, each member of the Board and the Attorney General.

